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No. 83-832

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1983

Harold T. and Marie B. Paulsen,

Petitioners,
vs.

Commissioner of Internal Revenue,

Respondent.

AMICUS CURIAE BRIEF OF CALIFORNIA LEAGUE OF SAVINGS INSTITUTIONS IN SUPPORT OF PETITIONERS

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INTEREST OF AMICUS CURIAE

The California Savings and Loan League ("California League") is a trade Association organized as a tax exempt organization pursuant to Section 501(c)(6) of the Internal Revenue Code. Its membership consists of substantially all of the savings and loan associations, both stock and mutual, authorized to conduct business within the State of California. As of the final quarter of calendar 1983, there were approximately 250 such associations, of which about 150, with a total of approximately $165 billion in assets, were stock companies; and the remainder, with a total of approximately $25 billion in assets, were mutuals. Hence it has a profound interest in assuring that the laws pertaining to the

taxation of savings and loan associations are properly interpreted.

II

ARGUMENT

A. <u>Under The Plain Language Of The Internal Revenue Code, As Heretofore Uniformly Interpreted By The Case Law, The Exchange, Pursuant to a Statutory Merger, By A Mutual Savings And Loan Association Of Its Stock In The Form Of Savings Accounts For The Guaranty Stock Of A Guaranty Stock Savings And Loan Association, Constitutes A Reorganization Within The Meaning Of Internal Revenue Code §368, And, Accordingly, Since The Savings Accounts Constitute Stock In A</u>

__Party To A Reorganization, The Exchange Is Tax Free At The Shareholder Level Under Internal Revenue Code §354__.

Internal Revenue Code §354(a)(1) provides, in pertinent part, that "[n]o gain or loss shall be recognized if stock . . . in a corporation a party to a reorganization . . . [is], in pursuance of the plan of reorganization, exchanged solely for stock . . . in such corporation or in another corporation a party to the reorganization". Accordingly, the applicability of §354(a)(1) -- as well as the applicability of other Internal Revenue Code sections applicable to corporations themselves, including for example, 361, 362(b), and 381 -- depends upon whether the stock

held by the taxpayer is stock "in a corporation [which is] a party to a reorganization". If the stock is in a corporation which is a "party to a reorganization", §354 applies; if the stock is not in a corporation which is a party to a reorganization, §354 does not apply.

The identity of corporations which are parties to reorganizations is determined by Internal Revenue Code §368. It provides, in pertinent part, that "the term 'a party to a reorganization' includes . . . a corporation resulting from a reorganization"; and that "the term 'reorganization'" means, inter alia ". . . a statutory merger or consolidation . . ."

In order for a transaction to constitute a "statutory merger or consolidation" within the meaning of §368,

concededly there must be a "continuity of proprietary interest" as between the acquired corporation and the acquiring or consolidated corporation, in the sense that the proprietary interest of the owners of the acquired corporation is continued in the acquiring corporation.

The total universe of proprietary interests in a mutual savings and loan association -- the total bundle of rights constituting "ownership" -- historically has been represented by the savings accounts of such association. Accordingly, since savings accounts have been the sole form of proprietary interest available to a mutual association, courts to whom the issue has been presented have, prior to the decision of the United States Court of Appeals for the Ninth Circuit in Paulsen, uniformly

have held that when a mutual association acquires a stock association, the "continuity of interest" requirement of §368 is satisfied by providing the stockholders in the stock association with savings accounts in the mutual in exchange for their stock.

In West Side Federal Savings and Loan Association v. U.S., 494 F.2d 404 (6th Cir. 1974), for example, the United States Court of Appeals for the Sixth Circuit rejected the argument that the providing of savings accounts in an acquiring mutual association to the stockholders of the acquired stock association did not satisfy the continuity of propriety interest requirement because the savings accounts lacked the necessary incidents of ownership and therefore should be treated as cash equivalents, explaining:

". . . since a savings account is the only proprietary interest available in a federal mutual savings and loan association and the former shareholders of Parma received such accounts in exchange for their stock, it is improper to ignore the proprietary rights included in what they received and concentrate only on their rights as creditors. In each of the cases dealing with continuity of interest the focus has been on the nature of the interest in the acquiring corporation which is received in the exchange. The courts do not conduct an examination to determine whether the shareholder of the merged corporation receives

more or less of a proprietary interest than he surrendered. Instead, it is an analysis to determine if a proprietary interest is received, and the fact that what is received may be a mixture of proprietary interests and debt instruments of the acquiring corporation is not alone determinative." (494 F.2d 411).

Accord:

<u>Capital Savings and Loan Association v. United States</u>, 607 F.2d 970 (Ct. Cl. 1979);

<u>Everett v. United States</u>, 448 F.2d 357, 359 (10th Cir. 1971).

See also:

<u>Rocky Mountain Federal Savings and Loan Association v. United</u>

States, 473 F.Supp. 779 (D.WY. 1979);

First Federal Savings and Loan Association v. United States, 452 F.Supp. 32 (N.D. OH 1978).

In the instant case, a mutual savings and loan association, Citizens Federal Savings and Loan Association ("Citizen"), acquired, pursuant to a statutory merger, a guaranty stock savings and loan association, Commerce Savings and Loan Association ("Commerce"), by exchanging its stock, in the form of savings accounts, for the guaranty stock of Commerce. Since the savings accounts constitute stock in a party to a reorganization, the exchange was tax free at the shareholder level under §354.

Why, then, did the United States Court of Appeals for the Ninth

Circuit conclude in Paulsen that §354 was inapplicable and that therefore the exchange of stock in Citizens for stock in commerce was not tax free at the stockholder level?

The Court reasoned, in essence, that because the issue was the applicability of a provision dealing with the tax consequences of a transaction to stockholders, §354, rather than the applicability of provisions dealing with the tax consequences to the corporation itself, satisfaction of the "continuity of interest" requirement depended not upon whether, from the corporate perspective, the stockholders in the acquired corporation continued to have an ownership interest in the enterprise but, rather, upon the characteristics of that ownership interest from the perspective of the stockholders; that the

"continuity of interest" test is not satisfied unless 1) the position of the stockholder before and after the merger is substantially unchanged in terms of the nature of his or her ownership interest and 2) the equity characteristics of the stock held in the merged corporation predominate over the debt characteristics thereof; that the fact that savings accounts "represent the entire capital structure" of a mutual association is "irrelevant . . . as far as §354 is concerned . . . [since] [t]he focus of that section is on the character of interests received from the point of view of the [shareholder] taxpayer, not that of the corporation"; that under Home Savings and Loan Association v. United States, 514 F.2d 1199 (9th Cir.), cert. den., 423 U.S. 1015 (1975), and

when viewed from the perspective of the shareholder taxpayer, the debt characteristics of savings accounts in a mutual association predominate over the equity characteristics; and that while "our decision conflicts with that reached by several other courts", including the decisions of the United States Court of Claims, in Capital Savings and Loan Association v. United States, supra, the United States Court of Appeals for the Sixth Circuit in West Side Federal Savings and Loan Association v. United States, supra, and the United States Court of Appeals for the Tenth Circuit in Everett v. United States, supra, "[w]e are neither bound nor persuaded by those authorities".

The merit -- or lack thereof -- in the reasoning of Paulsen has already been discussed, in extenso, in

the brief of Petitioners; and the League will not burden the Court by repeating their argument here. It does, however, have the following additional observations with respect to the Paulsen opinion.

First, and most basically, the fundamental premise of the opinion -- that the "continuity of interest" test is mutable and varies depending upon whether the issue is the application of a provision dealing with the tax consequences to the shareholder, such as §354, or the application of provisions dealing with the tax consequences at the corporate level, is false.

As the League has previously explained, §354 -- like reorganization provisions of the Internal Revenue Code such as §§361 and 362 applicable to corporations -- is derivative and

conditional. It applies when the stock held by the stockholder is in a "party to a reorganization"; the definition of "party to a reorganization" is contained in §368; and there is nothing in §368 or the case law interpreting it to suggest that satisfaction of the requirement that a corporation be a "party to a reorganization" depends upon whether the issue is the application of a provision dealing with tax consequences at the shareholder level or a provision dealing with the tax consequences at the corporate level. Indeed, any such determination would be an anomaly utterly devoid of any rational justification. Accordingly, the rationale invoked by Paulsen for using a "shareholder" perspective rather than a "corporate" perspective in applying the "continuity of interest" test simply is not valid.

Second, and as the League has also previously indicated, since the "continuity of interest" acquirement is a requirement at the corporate level the satisfaction of which must be determined based upon the perspective of the acquiring corporation, the characteristics of the stock held by the stockholders in the acquired corporation as compared to the characteristics of the stock received by the stockholders in the reorganized entity is immaterial. Hence all that is needed for "continuity of interest" is that the equity owners of the acquired guaranty stock association become equity owners in the reorganized entity, whatever the characteristics of that equity interest may be; and that requirement is clearly satisfied when the guaranty stockholders in the acquired association receive, in

exchange for their ownership interest, the only form of equity that the acquiring mutual association in Paulsen was empowered to issue -- its savings accounts.[1/]

1/ The Respondent himself has recognized the significance of the proprietary interests of the account holders in a mutual savings and loan by requiring that those account holders be fully compensated for such propriety interests in any corporate level reorganization affecting the mutual. If a federal mutual savings and loan is merged into a stock association, the transaction will not qualify as a reorganization under §368 unless the account holders of the acquired mutual receive stock in the acquiring stock association equal in value to the total equity interests in the acquired mutual, in addition to equal value share accounts. (Rev. Rul. 69-646, 1969-2 C.B. 54.) Moreover, for the conversion of a mutual savings and loan into stock form to qualify as a reorganization under §368, the converting mutual must: (i) first offer subscription rights to all of its new stock to its account holders; and (ii) credit its account holders with a liquidation account in an amount equal to the net worth of the mutual at the time of the conversion. (Rev. Rul. 80-105, 1980-1 C.B. 78.) Finally, for the merger of a mutual savings and loan into another

Third, the Home Savings decision -- which constitutes the entire precedential tax law foundation for Paulsen -- is manifestly inapposite. Home, held that the continuity of interest requirement was not satisfied in connection with the "mergers" of two stock chartered savings and loans into stock chartered Home Savings. In those

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mutual to qualify as a reorganization under §368(a), the account holders of the acquired mutual must receive equity in the acquiring mutual, in the form of equal value share accounts. (Rev. Rul. 69-3, 1969-1 C.B. 103).

In 1980, federally chartered mutual associations were authorized to issue mutual capital certificates as an additional method of raising capital. (Public Law 96-221, 94 Stat. 132, 12 U.S.C. §1464; 12 C.F.R. §544.2(b)(4); 12 C.F.R. §563.7-4(1)(2).) The classification of such mutual certificates as debt or equity for tax purposes has never been judicially determined in any reported case or publically passed upon by the Respondent. In any event, because of the limited rights that the certificates confer under current regulations, they would appear to be generally unmarketable.

mergers, the stockholders of the acquired associations received <u>solely cash</u> in exchange for their stock, while the savings account holders of the acquired associations received savings accounts in Home Savings. <u>The acquiring association</u>, Home Savings, <u>issued none of its permanent guaranty stock in connection with the mergers</u>. Further, any equity characteristics of the savings accounts issued by Home Savings were totally subordinated to the "real" equity interest in the association, its permanent guarantee stock. In <u>Paulsen</u>, by contrast, the acquiring association, because it was mutually organized, represented the paramount, and indeed the <u>only</u> proprietary interest in such association. Yet despite these startling differences in the relevant facts, <u>Paulsen</u> concludes that the savings accounts issued by Home

Savings are the appropriate focus for determining the outcome of the issues presented in Paulsen.

Finally, if the Paulsen decision were to be upheld, mutual savings and loan associations -- as well as other mutually organized corporations -- would be subjected to a new and arbitrary body of rules at both the corporate and shareholder levels that have never been applied to non-mutually organized corporations. There is nothing in either the language of the Internal Revenue Code or its legislative history which even remotely suggests an intent on the part of Congress to discriminate against any class of corporations, or their stockholders merely because of the

form of organization of such corporations.[2/]

2/ Arguably, however, the implications of <u>Paulsen</u> are far broader and more sinister than merely placing a limited category of corporations, mutual corporations, and the shareholders thereof in a disfavored status. <u>Paulsen</u> states that the "critical question" in determining whether or not the requirements for a reorganization have been satisfied is "whether the position of the shareholder in the reorganized entity has really changed . . ." Hence were <u>Paulsen</u> to be upheld, it would effectively overrule decisions, including decisions of this Court such as <u>Minnesota Tea Co. v. Helvering</u>, 296 U.S. 378 (1935) and <u>John A. Nelson Company v. Helvering</u>, 296 U.S. 374 (1935), holding that consolidations of non-mutual corporations could satisfy the requirements for a tax free reorganization notwithstanding the fact that the nature of what the exchanging shareholders held before and after the consolidation was qualitatively different.

B. <u>The Practical Effect Of Adopting The Paulsen Rationale That The Exchange Of Savings Accounts In A Mutual Association For Guaranty Stock Association Does Not Satisfy The "Continuity Of Interest" Requirement For A Reorganization Within The Meaning Of IRC §368 Would Have Adverse Tax Consequences At The Shareholder Level, And Harsh, And Indeed Confiscatory, Tax Consequences At The Corporate Level.</u>

As indicated in §III.A., *supra*, the practical effect of adopting the *Paulsen* rationale would be to preclude the direct acquisition of guaranty

stock savings and loan associations by mutual savings and loan associations from qualifying as tax freeing reorganizations within the meaning of §368. Instead the direct acquisition would be treated for tax purposes as though the stock association had sold its assets to the mutual association in a taxable transaction. LeTulle v. Scofield, 308 U.S. 415 (1940); Revenue Ruling 69-6, 1961 - 1 C.B. 104. The result would be adverse tax consequences at the shareholder level, with mutual savings and loan associations, unlike all non-mutual corporations, being unable to offer tax free consideration to shareholders in stock savings and loan association; and harsh, and indeed

confiscatory, tax consequences at the corporate level.[3/]

What are the tax consequences at the corporate level? They include the following:

1. Savings and loan associations, over more than three decades and pursuant to Internal Revenue Code §593 and its predecessors, have deducted from their taxable income and have accumulated enormous "bad debt" reserves not available to other corporate

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[3/] There has been extensive merger activity in the savings and loan industry (see Petition for Writ of Certiorari in the within proceeding, p. 22); and the Paulsen decision could have critically important tax consequences for many of those consummated mergers.

taxpayers.[4] In the case of a tax free reorganization within the meaning of Internal Revenue Code §368, such reserves are, pursuant to Internal Revenue Code §381(c)(4), carried over and treated as reserves of the acquiring association. Accordingly, no recapture

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4/ Savings and loans were, in general, exempt from taxation until taxable years beginning after 1951. The Revenue Act of 1951 Act subjected savings and loan associations to the normal corporate income tax but allowed bad debt deductions up to 100 percent of taxable income. Accordingly, until the passage of the Revenue Act of 1962, savings and loan associations could commit their entire taxable income to their bad debt reserve balances. The Revenue Act of 1962 amended §593 to reduce the maximum bad debt reserve deductions to 60 percent of taxable income. Finally, the Revenue Act of 1969 provided for a gradual stepdown in the taxable income ceiling for bad debt deductions of savings and loans, currently scheduled to remain at 40 percent of taxable income. Overall, the maximum bad debt reserve of a savings and loan association which can be taken under the "percentage of taxable income" method is limited to 6% of its "qualifying real property loans". Internal Revenue Code §593(b)(1)(C).

taxes need be recognized by the acquired corporation. If, however, the direct acquisition were not a tax free reorganization within the meaning of §368, then, as described in Capital Savings and Loan Association, 607 F.2d 970 (Ct. Cl. 1979), the merging stock association could be required to report the entire balance of its bad debt reserves in its gross income for its final tax year. See West Seattle National Bank of Seattle v. Commissioner, 33 T.C. 341 (1959) aff'd., 288 F.2d 47 (9th Cir. 1961); Arcadia Savings & Loan Association v. Commissioner, 300 F.2d 247 (9th Cir. 1962). See also Internal Revenue Code §593(e). The tax liability could be extremely large.

2. The vast bulk of the assets held by savings and loan associations consists of long term real property mortgage loans; and because of

historical economic factors and the resulting low interest yields on such mortgage loans in relation to current market rates, in recent years most of them have, on the average, had a fair market value which is substantially less than their face values.[5/] If the direct

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5/ In order to qualify as a savings and loan association for purposes of utilizing the special bad debt reserve allowances of § 593, a savings and loan must satisfy the definitional test requirements of Internal Revenue Code Section 7701(a)(19), as well as the asset investment test of Code Section 593(b)(2)(B). The net effect of such requirements is that a savings and loan which has taken full advantage of § 593 will have invested 82 percent or more of its assets in cash, government obligations and various types of real property mortgage loans. Savings and loans are also subject to regulatory proscriptions respecting permissible investments which, in practical effect limit a substantial percentage of their investment activity to residential real property lending. Home Owners' Loan Act of 1933, § 5 (12 U.S.C. § 1464(c)); California Financial Code §§ 7504, 7505. Nationwide deposits in FSLIC insured savings and loans totaled $793,858,000,000 in 1983; The real estate loan portfolios of such savings and loans approximate 70% of their total asset balances.

acquisition of a guaranty stock association by a mutual constitutes a reorganization under §368, the acquiring mutual association carries over the stock association's cost basis in the acquired mortgage loans and that cost basis is, for loans originated by the association, the amount advanced to the borrower less principal repayments to date. (See §362(b)). Accordingly, post acquisition repayments of principal by the borrower are treated as a return of capital and are not be taxable to the mutual association. If, however, the direct acquisition were characterized as a taxable purchase, the mutual's tax basis in the acquired mortgage loans would normally be limited to the

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Nationwide investments by FSLIC insured savings and loans in real property loans in 1983 totaled $132,442,000,000 in that year. U.S. League of Savings Institutions, '83 Savings and Loan Sourcebook 8 (1983); 17 Federal Home Loan Bank Board Journal, 45, 50-52 (March, 1984).

mutual's cost basis, specifically the fair market value of those loans as of the date of acquisition thereof by the mutual association. (Code Section 1012). For tax purposes, these below market yield loans would be treated as discount obligations in the hands of the acquiring mutual association. Portions of the periodic repayments of principal by borrowers would be recharacterized as discount income and become subject to tax at ordinary interest rates. Hence the mutual would, as the result of the direct acquisition, assume a substantial deferred tax liability to be repaid over the life of the acquired loan portfolio. <u>Burbank Liquidating Corporation v. Commissioner</u>, 39 T.C. 999 (1963) modified 335 F.2d 125 (9th Cir. 1964), acq. 1965-1 C.B. 5; <u>Darby Investment Corporation v. Commissioner</u>, 37

T.C. 839 (1962), aff'd., 315 F.2d 551 (6th Cir. 1963); Revenue Ruling 73-558, 1973-2 C.B. 298.[6]

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[6] To illustrate the aggregate effect of the tax consequences referred to in items 1 and 2 herein above, assume that the acquired stock association held $100 million in mortgages, with a current discounted fair market value of $85 million in mortgage loan; that the association has accumulated $3 million in bad debt reserve balances for federal income tax purposes, one-half the maximum allowable under the "percentage of taxable income" method of computing bad debt reserves set forth in §593(b)(2); and a net worth equal to 4% of assets, an amount approximately equivalent to the industry average. Federal Home Loan Bank, Statistical Division, Office of Policy and Economic Research, Washington, D.C. (Dec. 1983). If the direct acquisition does not qualify as a reorganization for purposes of Code Section 368(a)(1)(A), the stock association may be required to report $3 million dollars in taxable bad debt reserve recapture income in its final return, resulting in a tax liability of approximately $1,380,000, computed at maximum corporate tax rates. Further, the acquiring mutual would be required to report $15 million of ordinary discount income arising out of its ultimate collection of the $100 principal balance on the acquired mortgage loans, resulting in tax liabilities of approximately $4,140,000, computed at maximum corporate tax rates (after

3. Because of the adverse economic experience of the savings and loan industry over the past several years, many associations have had net operating and capital loss carryovers, unused investment credits, work incentive program credits and employee stock ownership credits. If the direct acquisition of a stock association by a mutual constitutes a reorganization under §368, such carryovers and credits of the merging stock association, would, pursuant to Internal Revenue Code §381(a)(2) and subject to the restrictions of Internal Revenue Code §§382(b)

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giving full effect to the bad debt deduction provided by §593(b)(2), but without considering the tax preference effect of Internal Revenue Code §57(a)(7).) The total additional corporate level tax liabilities tax liabilities resulting from this transaction could exceed the net worth of the association.

and 383, be carried over to the mutual. Otherwise they would be lost.[7/]

4. If direct acquisition of a stock association by a mutual is a reorganization under §368, the stock association would be entitled to the benefits of §361, providing for no recognition of gain or loss for tax purposes by the acquired association. Otherwise the direct acquisition would be treated as a Internal Revenue Code §337 sale of assets in the course of the complete liquidation of the stock association; and the merging stock association would be subject to depreciation recapture under §§1245 and 1250, recapture of the investment tax credits under §47(a), and to general legal principles applying the

7/ Stock associations seeking to acquire the business of other stock associations by means of a direct stock for assets merger would, however, be in the position to utilize the carryover provisions of §381(a)(2).

tax benefit doctrine, the assignment of income doctrine, and the "clear reflection of income" doctrine of §446(b) for the purpose of imposing additional taxes upon a liquidating corporation. (See, e.g., Bliss Dairy v. United States, 103 S.Ct. 1134 (1983), reversing 645 F.2d 19 (9th Cir. 1981); Idaho First Nat'l Bank v. United States, 265 F.2d 6 (9th Cir. 1959) (accrued but not yet due or payable interest taxed to liquidating cash basis bank).

III

CONCLUSION

The decision of the United States Court of Appeals for the Ninth Circuit in Paulsen is contrary both to settled law and sound public policy. It should be reversed.

Respectfully submitted,

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